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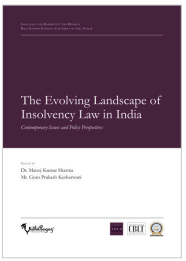
CHAPTER 14

Reassessing Taxation on Haircuts: A Case for MSME Recovery under India's Pre-Packaged Insolvency Framework



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CHAPTER 14

Reassessing Taxation on Haircuts: A Case for MSME Recovery under India's Pre-Packaged Insolvency Framework

KARAMPUDI SRI AVANI SATHYA*

India's vibrant insolvency regime has been in the limelight for its responsiveness to sectoral concerns, best illustrated by the introduction of Pre-Packaged Insolvency Resolution Process ("PPIRP") in 2021, particularly for Micro, Small, and Medium Enterprises ("MSMEs"), to ensure their efficient and feasible revival from the drastic cash flow disruptions and business impacts they faced due to COVID-19. While the policy framework under the Insolvency and Bankruptcy Code, 2016 ("IBC"), addresses the growing need for swift and effective revival of insolvent MSMEs, there is a long way to go to ensure its effective implementation and achieve the legislative intentions behind these reforms.

One area that warrants reappraisal is the taxation of haircuts granted to MSME debtors in a restructuring process. Taxing forgiven debt increases the financial burden on an already liquidity-constrained entity, aggravating post-resolution liquidity crises. It also contracts the total pool of recoverable assets, disincentivising creditors from providing significant haircuts. This is especially pressing, given that median haircuts have risen sharply from 64% in FY23 to 73% in FY24, and the median time to resolution has skyrocketed to 834 days. This prolonged resolution process, combined with deep haircuts and additional tax charges, undermines the PPIRP's main aim, eroding the MSME recovery environment.

The paper's primary purpose is to address an important lacuna in the Indian insolvency regime by placing the interaction between taxation policy and insolvency law at the centre stage. It advocates a strategic fiscal policy intervention to ensure that taxation does not undermine the PPIRP's revival goals (and, in turn, the IBC's). In the process, it brings a new and persuasive voice to the MSME rehabilitation and insolvency reform debate in India, which is economically realistic and legally sophisticated.

The paper addresses this concern in a fourfold manner. It begins by outlining the rationale for introducing the PPIRP and recognising MSMEs' specific financial vulnerabilities. Secondly, it conducts a critical examination of existing tax governance regarding haircuts under Indian law and discusses its implications for business viability upon resolution. Thirdly, it provides a comparative policy analysis, drawing on legal frameworks that provide preferential tax schemes for distressed debt resolution. Lastly, it proposes policy

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recommendations, including an initiative to provide preferential tax treatment for haircuts for MSMEs undergoing PPIRP.

Keywords: Insolvency Execution, Debt Haircut, MSME Insolvency

1 INTRODUCTION

MSMEs form the backbone of the Indian economy. With a contribution of almost 30% to India's GDP[1] and employing over 21.17 crore individuals,[2] these enterprises are a bastion of economic resilience, regional growth, and employment generation. On a similar scale, MSMEs account for 95% of industries globally and 60% of employment across the world, making them an indispensable part of sustainable economic systems.[3] While they are of systemic importance, MSMEs, by their very nature, are extremely vulnerable to external shocks due to their fragile financial structures and their susceptibility to credit.[4] These vulnerabilities became distinctly apparent during the COVID-19 pandemic, leading to unprecedented liquidity crises across the sector.[5]

Owing to this structural weakness, the Indian insolvency framework introduced the PPIRP in 2021 under the IBC.[6] PPIRP was initiated as a quick, low-cost, and low-disruption instrument specially for MSMEs.[7] It combines the informality of out-of-court negotiations with the legal certainty of formal adjudication. Its debtor-in-possession framework under the supervision of financial creditors enables stakeholders to draft a base resolution plan,[8] even before initiating formal insolvency proceedings, and then submit it before the National Company Law Tribunal (NCLT) (the Adjudicating Authority) for authorisation.[9] This hybrid framework is intended to avoid delays, preserve the value of the debtor's assets, and enable early intervention, factors pivotal to MSME survival.[10]

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[1] Abhishek Sharma, *PPIRP: A Pre-Packaged Solution for MSMEs with a Post-Dated Cheque*, BUS. WORLD (Nov. 25, 2024), https://www.businessworld.in/article/ppirp-a-pre-packaged-solution-for-msmes-with-a-post-dated-cheque-540152.

[2] *Over 4.91 Crore Enterprises Registered, Udyam Portal Transforms MSME Landscape*, PRESS INFORMATION BUREAU (Aug. 29, 2024), https://www.pib.gov.in/PressNoteDetails.aspx?NoteId=152063&ModuleId=3.

[3] *Informal Working Group on Micro, Small and Medium-Sized Enterprises (MSMEs)*, WORLD TRADE ORGANIZATION, https://www.wto.org/english/tratop_e/msmes_e/msmes_e.htm (last visited Aug. 3, 2025).

[4] Alekha Charan Rout & Dr. Girija Shankar, *Pre-Packaged Insolvency Resolution Process (PPIRP) Under the Insolvency & Bankruptcy Code (IBC), 2016: Why a Non-Starter?*, 57 MGMT. ACCT. J. 88, 88 (2022), https://doi.org/10.33516/maj.v57i10.88-93p.

[5] *Id.*

[6] IBBI, *Pre-Packaged Insolvency Resolution Process* (July 2021), https://www.ibbi.gov.in/uploads/whatsnew/a650764a464bc60fe330bce464d5607d.pdf.

[7] INSOLVENCY LAW COMM., REPORT OF SUB-COMMITTEE OF THE INSOLVENCY LAW COMMITTEE ON PRE-PACKAGED INSOLVENCY RESOLUTION PROCESS 13 (2020).

[8] Rout & Shankar, *supra* note 4, at 91.

[9] IBBI, *supra* note 6.

[10] INSOLVENCY LAW COMM., *supra* note 7, at 22.

The IBC takes jurisprudential inspiration from both communitarian and contractarian models. It reflects communitarian tendencies by giving priority to business survival and rehabilitation,[11] ensuring long-term economic value creation, and espousing creditor primacy and contractual discipline under contractarian expectations.[12] India's insolvency practice successfully balanced both, as could be seen post-IBC, which made great strides in its brief tenure. The World Bank's 'Ease of Doing Business' 2020 report recorded India's sharp ascent in the insolvency resolution ranking from 108 in 2018 to 52,[13] which is a testament to more robust institutional frameworks and judicial efficiency.

Yet it remains an evolving field with numerous persistent lacunae. Here, in the context of PPIRP, it exists only in the form of patchy and incomplete implementation. As recently emphasized at IBBI's 8th Annual Day, problems like long resolution durations, high haircuts, and absence of early-stage interaction still bedevil the ecosystem.[14] The numbers: median resolution time of 834 days, and average haircuts of 73%, in FY24,[15] further only exacerbate the situation. Furthermore, given the fact that MSMEs represent ₹27.7 lakh crore of outstanding debt (as of October 2023),[16] these inefficiencies are not marginal; they attack the very heart of financial sector stability.

One of the underexamined friction points that potentially hinders the successful implementation of insolvency processes/plans is the taxation levied on the debts forgiven by creditors (the haircuts). Haircuts are an essential tool of restructuring which are currently being taxed as income in the hands of the corporate debtor. Not only does this aggravate liquidity stress, but it also critically reduces the efficacy of the entire resolution process.[17]

This paper argues that taxing haircuts is a doctrinal anomaly and a policy mismatch that immediately threatens the success of MSME insolvency recovery, and that rectifying this could aid in achieving the implementation goals of PPIRP. It proposes preferential taxation of haircuts to align the tax regime with the IBC's legislative objectives and advises a targeted

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[11] M P Ram Mohan & Sai Muralidhar K, *Taxation and Insolvency: Towards a Foundational Understanding*, IBBI 21, 33 (2024), https://ibbi.gov.in/uploads/whatsnew/2024-10-04-181657-17py3-8b35dbeca4577105ca46c15e1508dc2c.pdf.

[12] *Id.* at 28.

[13] *India Jumps 14 Places in World Bank's Doing Business Report 2020*, MAKE IN INDIA, https://www.makeinindia.com/india-jumps-14-places-world-banks-doing-business-report-2020 (last visited Aug. 3, 2025).

[14] Aggam Walla & Sukalp Sharma, *With Long Delays and Steep Haircuts, Chorus for Revamping Insolvency and Bankruptcy Code Grows Louder*, INDIAN EXPRESS (Oct. 6, 2024), https://indianexpress.com/article/business/economy/with-long-delays-and-steep-haircuts-chorus-for-revamping-ibc-grows-louder-9605768/.

[15] Sharma, *supra* note 1.

[16] *Creditors' Haircuts in Bankruptcy Cases Jump to 73 pc in FY24, Resolutions Taking Longer: Report*, ECON. TIMES (May 17, 2024), https://economictimes.indiatimes.com/industry/banking/finance/creditors-haircuts-in-bankruptcy-cases-jump-to-73-pc-in-fy24-resolutions-taking-longer-report/articleshow/110210505.cms?from=mdr.

[17] Irving Aw, Brendan Crowley & Jose M. Garrido, *Should Tax Be King? The Debate over Tax Priority in Insolvency* (IMF, WP/25/118, 2025).

fiscal policy review in this direction to deliver a more sustainable and equitable recovery framework for MSMEs.

2 HAIRCUTS AND THE TAX HURDLE IN MSME INSOLVENCY

The PPIRP is essentially geared to maintain the viability of MSMEs through a time-bound and concerted resolution process. It facilitates early intervention in financial distress, enabling stakeholders to halt the erosion of the debtor's assets and thereby uphold the creditor's confidence and interests.[18] In addition to value maximisation, the mechanism of voluntary intervention by the debtor facilitates simpler and quicker resolution, and promotes the least disruptive recovery, outcomes critical to the survival of financially stressed MSMEs,[19] as already noted above. All these characteristics indicate that it is essential to enhance the implementation of the process, which is currently quite meagre.[20]

The use of haircuts is a keystone for the success of the PPIRP. In bankruptcy law, a haircut is the shortfall in the recovery of creditors' original claims.[21] It is essentially a stepped write-down enabling creditors to forego recovery in part in return for the possibility of reviving the debtor. In insolvency restructurings, where liquidation will most likely produce value distant from the going concern potential,[22] haircuts are a necessary compromise that enables ongoing operations, job preservation, and derivative economic activity.

> "Tax administration in insolvency is a devouring monster."[23]

Though slightly exaggerated, it represents a true picture within the Indian tax framework, which subjects the quantum of debt waived under the resolution plan to tax as the income of the corporate debtor. It is a commercially harmful treatment. The so-called "income" out

[18] Several legislative guides on insolvency law implementation, especially for MSME recovery, constantly stressed the importance of early intervention with financial distress. *See* UNCITRAL, UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW FOR MICRO- AND SMALL ENTERPRISES 47 (2022).

[19] INSOLVENCY LAW COMM., *supra* note 7.

[20] As of March 2023, only eight cases have gone through the PPIRP. *See* IBBI, *IBC: Evolution, Learnings and Innovation* (Oct. 1, 2023), https://www.iima.ac.in/sites/default/files/2023-10/Pre-Packs_IBBI_Annual%20Publication_2023.pdf.

[21] Debajyoti Ray Chaudhuri, *The Haircut That Never Was: Need to Factor in Whether a Loan Account Had Become an NPA While Assessing Haircut from Its Resolution Under IBC*, IBBI (Aug. 6, 2021), https://ibbi.gov.in/uploads/resources/cf9e3f8a658e837ba704fc8594670a68.pdf.

[22] Reports show that creditors received 200% of liquidation value while reviving. *See* MS Sahoo, *Moving Up in 'Ease of Resolving Insolvency'*, IBBI, https://ibbi.gov.in/uploads/whatsnew/faf3af70524e6c7ccf0b6762ab70216c.pdf (last visited Aug. 3, 2025).

[23] Comment made in a 1967 paper referred to by the IMF in its working paper which debated the need for tax priorities in insolvency proceedings. *See* Aw, Crowley & Garrido, *supra* note 17.

of a haircut is not a result of cash flow at all.[24] It is an accounting fiction created by the Indian Accounting Standards.[25] To tax a waiver of this kind is to turn a restructuring solution into a fiscal burden, thereby penalizing entities for availing the very relief meant to rescue them.[26]

For MSMEs, the effect of this tax treatment is particularly severe. The problem is compounded by the absence of post-insolvency finance for MSME debtors,[27] and they have to survive on the relief provided by the restructuring to get solvent once more. Taxing haircuts negates the economic benefit of resolution and, in effect, restores insolvency risks shortly after the plan is implemented. This further disincentivises MSME debtors from initiating insolvency proceedings at early stages. In this way, the tax regime thwarts not only the intent of the PPIRP but the entire policy agenda of MSME rehabilitation.

Besides, the tax imposition also has a deterrent effect on creditor behaviour. Since haircuts made in good faith will be subject to tax and absorbed before they can resume operations, creditors may hesitate to make voluntary haircuts.[28] Both the pool of debtor's assets and the likelihood of the corporation's successful revival are affected. This reduces the range of feasible restructuring plans, makes the filing for PPIRP less attractive, and ultimately undermines the spirit of cooperation required for it to work.

The policy position is also uncomfortably at odds with the state's intent to rescue MSME players during times of crisis. Scholarly arguments, according to the IMF, note that "tax priorities (by the state) will actually amplify the negative effect of tax claims over third parties at a time of crises".[29] It also correctly points out the fact that states often pursue contradicting policies: on one hand, giving subsidies and bringing policy changes to support SMEs (such as PPIRP, Credit Guarantee Trust Fund for Micro and Small Enterprises)[30] and on the other hand, recovering taxes during insolvency.[31] So, if the aim is to encourage early, value-protecting, out-of-court resolutions, then taxing key restructuring instruments, such as haircuts, is not merely counterintuitive but also counterproductive.

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[24] Aurelio Gurrea-Martinez & Vincent Ooi, *The Tax Treatment of Haircuts in Financial Reorganizations*, 27 REVENUE L.J. 1, 3 (2020), https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?params=/context/sol_research/article/5128/&path_info=A035._The_Tax_Treatment_of_Haircuts_in_Financial_Reorganizations.pdf.

[25] IndAS, *infra* note 44.

[26] Gurrea-Martinez & Ooi, *supra* note 24, at 12.

[27] Rout & Shankar, *supra* note 4, at 91.

[28] Gurrea-Martinez & Ooi, *supra* note 24, at 12. It is crucial to note that formal lenders are also hesitant to take 'voluntary haircuts', due to fear of 'allegations of impropriety'. *See IBC Au-Courant*, INSOLVENCY PROFESSIONAL AGENCY OF INSTITUTE OF COST ACCOUNTANTS OF INDIA (Sept. 13, 2022), https://www.ipaicmai.in/IPANEW/Uploadfiles/Newsletters/NL_13092022073127.pdf.

[29] Aw, Crowley & Garrido, *supra* note 17, at 28.

[30] *Schemes for MSMEs*, MAKE IN INDIA, https://www.makeinindia.com/schemes-msmes (last visited Aug. 4, 2025).

[31] Aw, Crowley & Garrido, *supra* note 17, at 28.

Considering the World Bank benchmark for the measurement of insolvency outcomes, which is a function of time, cost, and recovery value, it can be ascertained that due to taxation of haircuts, the resolution incurs more costs, slows down the process, and reduces chances of successful recovery, and as a result, India's overall insolvency performance sees a reduction.[32]

MSMEs thrive in an extremely tight financing market where any additional fiscal cost, and especially one that is unwarranted and does not reflect real gains, is a structural obstacle to resolution success. Where the sustainability of business hinges on fiscal space, taxing notional profits is a direct disincentive to economic growth.

3 TAXATION OF HAIRCUTS IN INDIAN LAW: LEGISLATIVE AND JUDICIAL FRAMEWORK

Given the destructive effects of taxation on the MSME insolvency environment, it is imperative to examine the statutory provisions imposing such tax liabilities and the judicial stance on the subject, identifying any inconsistencies. Further, this section evaluates the provisions that add to the fiscal burden and cause policy asymmetries and identifies the judicial leaning on tax priorities.

3.1 Statutory Basis for Taxation

3.1.1 Section 28(iv): Benefits or Perquisites Arising Out of Business

Section 28(iv) of the Income Tax Act, 1961 charges tax on any "benefit or perquisite" arising from the exercise of a profession or business, whether in monetary form or otherwise.[33] The scope of the section, which previously covered only benefits not in the form of money, was widened by the Finance Act, 2023, to include waived loans and cash haircuts.[34]

Before this amendment, in *The Commissioner v. Mahindra & Mahindra Ltd.,* the Supreme Court held that the waiver of a term loan was not taxable under section 28(iv) because the benefit was in cash and not a perquisite in kind.[35] This view was, however, rendered redundant by the post-2023 legislative amendment.

Even with the amendment, this section still requires the benefit to arise out of business. Courts such as the Gujarat High Court in *CIT v. Chetan Chemicals Pvt. Ltd.* have made it clear that waiver of a loan cannot be treated as a benefit (under the provision), as it cannot be said that the business of the assessee is to obtain loans. Therefore, the waiver of such loans

[32] IBBI, *supra* note 20.
[33] The Income Tax Act, 1961, § 28(iv).
[34] The Finance Act, 2023, § 11.
[35] Commissioner v. Mahindra & Mahindra Ltd., MANU/SC/0513/2018.

cannot be considered a benefit of such a business.[36] A similar approach was taken in the cases of *CIT v. Gujarat State Fertilizers and Chemicals Ltd.*,[37] and *ITO v. Undavalli Constructions.*[38] The apex court has not yet clarified the ambiguity. So it leaves an open-ended question whether the recipient of such a waiver must necessarily be involved in a business of loans, or whether, as the loan is a crucial part of the conduct of business, such a waiver would come under the ambit of the section regardless of the assessee's business. Thus, business nexus is still a sine qua non for invocation even after the amendment.

3.1.2 Section 41(1): Cessation or Remission of Trading Liabilities

Section 41(1) of the Income Tax Act considers any cessation or remission (waiver or surrender) of a trading liability, upon which benefit or deduction has already been claimed earlier, to be a taxable income in the year in which the said waiver of liability takes place.[39] In *Mahindra & Mahindra*, the Supreme Court ruled that, because the loan in question was neither a trading liability nor one previously claimed as a deduction, section 41(1) did not apply.[40] Meaning, the provision is narrow and has two cumulative requirements:

a. The liability in question must be a "trading liability" only, and

b. A deduction or allowance must have been taken on that liability previously.

The same has been adhered to in *CIT v. Kesaria Tea Co. Ltd.*[41] as well. It is crucial to note that the judiciary, through various case laws, also distinguished what types of liabilities come under the ambit of the term "trading liability". For example, "working capital borrowing" is considered a trading liability,[42] while "tooling" is considered a capital asset and does not fall under the purview of this section.[43] Therefore, whether the assessee will be taxed here depends on the nature of the loan forgiven and the benefits he had received before the waiver of the said loan.

3.1.3 Section 115JB: Minimum Alternate Tax (MAT)

Even if a corporate debtor is exempted from taxation under sections 28(iv) or 41(1), section 115JB of the Income Tax Act comes into play as the default tax provision. The provision applies to the "book profits" calculated under Indian Accounting Standards (IndAS).

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[36] Comm'r of Income-Tax v. Chetan Chems. Pvt. Ltd., (2004) 267 ITR 770.

[37] CIT v. Gujarat State Fertilizers & Chems. Ltd., (2013) 358 ITR 323.

[38] Income Tax Officer v. Undavalli Constrs., MANU/IV/0046/2021.

[39] The Income Tax Act, 1961, § 41(1).

[40] Commissioner v. Mahindra & Mahindra Ltd., MANU/SC/0513/2018.

[41] CIT v. Kesaria Tea Co., (2002) 3 SCC 684.

[42] Logitronics P. Ltd. v. CIT, (2011) 333 ITR 386.

[43] Mahindra & Mahindra Ltd. v. Comm'r of Income-Tax, 2003 SCC OnLine Bom 1261.

Under IndAS 109, which takes an accountant's perspective on taxation, the derecognition of a financial liability, or a part of it, must be recognised as a gain in the profit and loss account.[44] Such notional gain, therefore, improves book profits and gives rise to MAT liability, without at all increasing the financial position of the debtor.

While section 115JB provides limited relief to insolvent companies by allowing the deduction of carry-forward losses and unabsorbed depreciation, the initial amount of the haircut is not exempt and must be passed through the P&L.[45]

Here, it is worth noting that the judicial opinions are again bifurcated. In cases such as *JSW Steel Ltd. v. Asst. CIT,*[46] and *Shree Cement Ltd. v. Addl. CIT,*[47] a loan waiver was treated as a capital receipt, and the applicability of MAT was exempted. But on the other hand, we also have rulings supporting the MAT applicability based on the principles of accounting, such as *B&B Infotech Ltd. v. ITO,*[48] and *Duke Offshore Ltd. v. Dy. CIT*.[49] While, in the author's opinion, it is legitimate to tax such a waiver, the lack of conformity regarding the status of MAT applicability leaves another open-ended question.

From the above, it is evident that regardless of the nature of the loan on which a relief is given to the MSME debtor, in some way or another, there could be a channel to tax it (subject to judicial scrutiny as seen by contradicting judgements above). These represent the practical angle that impacts the business viability and recovery environment of MSMEs, as discussed in the previous part.

3.2 Other Asymmetrical Tax Policies

3.2.1 Section 115BAA: Exclusion from MAT

Section 115BAA of the Income Tax Act provides a concessional rate of 22% plus surcharge and cess to domestic companies[50] and exempts them from section 115JB MAT.[51] But at the cost of enormous trade-offs: the company would be required to account for all other

[44] Companies (Indian Accounting Standards) Rules, 2015, Ind AS 109, G.S.R. 111(E), Gazette of India, pt. II sec. 3(i), at 823 (Feb. 16, 2015).
[45] The Income Tax Act, 1961, § 115JB.
[46] JSW Steel Ltd. v. Assistant Comm'r of Income-tax, Circle 11(5), Bangalore, [2017] 82 taxmann.com 210.
[47] Shree Cement Ltd. v. Additional Comm'r of Income-tax, [2014] 49 taxmann.com 274.
[48] B & B Infotech Ltd. v. Income-tax Officer, Ward 12(1), Bangalore, [2015] 63 taxmann.com 122.
[49] Duke Offshore Ltd. v. Deputy Comm'r of Income-tax 10(1), Mumbai, [2011] 9 taxmann.com 214.
[50] The Income Tax Act, 1961, § 115BAA.
[51] Several authorities believe exemption from MAT is necessary to avoid unnecessary fiscal burdens for companies going through insolvency. *See* S.R. Patnaik, Reema Arya & Shivam Garg, *Unfolding Tax Tools to Invigorate Resolution of Companies Under IBC*, CYRIL AMARCHAND MANGALDAS (Feb. 8, 2024), https://tax.cyrilamarchandblogs.com/2024/02/unfolding-tax-tools-to-invigorate-resolution-of-companies-under-ibc/.

concessions and deductions, such as carry-forward of losses and unabsorbed depreciation,[52] reliefs that are often the most critical to post-insolvency turnaround.

In addition, opting for 115BAA does not exclude the assessee from the application of sections 28(iv) and 41(1). The exposure merely shifts from one clause to another. Section 115BAA is thus at best a half-shield with narrow coverage due to procedural inflexibility and is subject to conditional relief.

3.3 Tax Arbitrage

The unequal tax treatment of debtors and creditors exacerbates the financial strain. A classic example of tax arbitrage occurs when debtors are liable under several provisions while creditors are exempt from paying taxes on amounts that have been waived. According to Glen Loutzenhiser, "tax treatment of the parties to a transaction should generally be symmetrical to prevent arbitrage opportunities".[53] This disparity was also evident in CBDT Circular 18/2022, which explicitly mentioned no relief to debtors but exempted creditors from TDS (u/s. 194R)[54] obligations on waivers.[55] The IBC's goal of transparent and equitable insolvency outcomes is undermined by this asymmetry, which also deters formal resolution and could encourage opaque, informal settlements.

3.4 Judicial Leaning Towards Favourable Tax Treatment

Further, it becomes necessary to make note of two important case laws: (1) *Ghanashyam Mishra and Sons Pvt. Ltd. v. Edelweiss Asset Reconstruction Company Ltd.*,[56] and (2) *Pr. Director General of Income Tax (Admin & TPS) & Ors. v. Synergies Dooray Automotive Ltd. & Ors.*[57] These cases convey the judiciary's leaning towards less or no tax imposition on a corporate debtor emerging from an insolvency process.

In *Ghanashyam Mishra*, the apex court noted that if the resolution plan approved by the adjudicating authority contains no mention of payments to the tax authorities, i.e., if the tax liabilities are exempted in the approved resolution plan, it shall be binding on all stakeholders, including the statutory authorities.[58] Here, the NCLT clearly did not uphold the priority of tax payments, which points to the above-mentioned leaning tendency among the

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[52] Kushal Parikh & Mehul Bheda, *India: The Interplay of India's New Insolvency Code with Income Tax Law*, INT'L TAX REV. (Feb. 9, 2020), https://www.internationaltaxreview.com/article/2a68rfy5bw2ycq1wn3hf4/india-the-interplay-of-indias-new-insolvency-code-with-income-tax-law.

[53] Gurrea-Martinez & Ooi, *supra* note 24, at 16.

[54] The Income Tax Act, 1961, § 194R.

[55] Ministry of Finance, Circular No. 18/2022/F. No. 370142/16/2022-TPL (Sept. 13, 2022).

[56] Ghanashyam Mishra & Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co., (2021) 9 SCC 657.

[57] Pr. Director General of Income Tax (Admin & TPS) v. Synergies Dooray Automotive Ltd., CA (AT) (Ins.) No. 205 of 2017 (NCLAT).

[58] Ghanashyam Mishra & Sons (P) Ltd. v. Edelweiss Asset Reconstruction Co., (2021) 9 SCC 657.

adjudicating authorities and the Supreme Court to recognise the binding nature of the Tribunal's decisions.

In *Synergies Dooray*, "downward settlement of crystalized tax liability"[59] was upheld. In clearer terms, NCLT Hyderabad, in this case, allowed a very steep haircut of 99% on the income tax payable by the corporate debtor, noting that all statutory dues are dues pending to operational creditors and they should be subjected to providing significant write-offs to ensure that the corporate debtor rises as a viable entity post-insolvency.[60] Hence, it shows the judicial support for the least priority of tax dues in insolvency proceedings.

Ultimately, the decision of whether to levy tax dues on an already distressed entity (which could affect its full recovery, particularly for MSMEs) comes down to a policy choice. What is needed is preferential tax treatment for loan forgiveness under NCLT-approved resolution plans. Only then will India's insolvency and fiscal regimes be in sync rather than at loggerheads, making PPIRP a dependable and effective instrument for MSME revival.

4 COMPARATIVE ANALYSIS: INSPIRATIONS FROM FOREIGN JURISDICTIONS, POLICY GUIDES, ETC

4.1 Practices in Foreign Jurisdictions: USA and UK

Internationally, the mature insolvency regimes have long recognised the imperative for beneficial tax treatment of debt forbearance. Notably, Chapter 11 of the United States Bankruptcy Code, at 26 U.S.C. § 108, provides that any debt decreased or discharged under a confirmed reorganisation plan is not considered taxable income.[61] This helps the corporate debtor to leave insolvency in a financially healthy state,[62] thus increasing chances of a true turnaround.[63] The logic is simple: if a haircut is the cost of staying alive, to tax it goes against the very spirit of restructuring.

Equally, in the United Kingdom, statutory schemes of arrangement identify waivers as necessary relief and explicitly exclude such incentives from tax calculations. Waivers, although accounted for, are not treated as income for tax purposes.[64] This is based on the

[59] Pr. Director General of Income Tax (Admin & TPS) v. Synergies Dooray Automotive Ltd., CA (AT) (Ins.) No. 205 of 2017 (NCLAT).
[60] *Id.*
[61] 26 U.S.C. § 108 (2018).
[62] Gurrea-Martinez & Ooi, *supra* note 24, at 13.
[63] *Debt Restructuring: International Tax Considerations*, NORTON ROSE FULBRIGHT, https://www.nortonrosefulbright.com/en-gb/knowledge/publications/3f5f5dbb/debt-restructuring-international-tax-considerations (last visited Aug. 4, 2025).
[64] *Corporate Finance Manual*, GOV.UK (July 16, 2025), https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm33190.

understanding that notional gains do not amount to real economic enrichment, particularly when occurring through insolvency procedures.

4.2 Policy Guidelines from International Organizations: UNCITRAL and World Bank

Foreign best practices are also reflected in the standard-setting materials of organisations such as UNCITRAL and the World Bank. The 'UNCITRAL Legislative Guide on Insolvency Law for Micro and Small Enterprises (MSEs)' promotes: (1) tax relief mechanisms that encourage timely disclosure and restructuring of obligations;[65] (2) fiscal and accounting rules favouring transparency rather than opacity;[66] and (3) tax exemption or relief for debt cancelled by formal procedures[67] to induce institutional resolution as opposed to informal workouts.[68] The World Bank also emphasises that successful MSME insolvency regimes must provide for the discharge of individual entrepreneurs' debts, reinforcing the notion that a clean exit and incentivising creditor participation are fundamental to economic re-engagement.[69] In the absence of such an arrangement, the distress cycle deepens, especially for smaller enterprises with poor capital resilience.

4.3 Lessons from Precedents: Wisdom of SICA

Interestingly, India's own policy choices in its past legislation reinforce the same approach. The erstwhile repealed Sick Industrial Companies (Special Provisions) Act, 1985 (SICA) also exempted book profits of sick companies from MAT liability for the rehabilitation period.[70] Waivers accounted under restructuring were not regarded as actual income according to the then accounting principles, and were exempted from taxation liability.[71] This historical precedent reflects the Indian state's prior recognition of the non-taxable nature of insolvency-driven waivers.

In addition, in 2017, ASSOCHAM (Associated Chambers of Commerce and Industry of India) strongly recommended that waivers provided under an IBC-approved resolution plan must not be taxed under general provisions or MAT, and that the tax treatment under

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[65] UNCITRAL, *supra* note 18, at 50.
[66] *Id.* at 47.
[67] *Id.* at 42, 113, 116.
[68] *Id.* at 33.
[69] WORLD BANK, REPORT ON THE TREATMENT OF MSME INSOLVENCY 34 (2017).
[70] Payaswini Upadhyay, *Insolvency Law: Case for Tax Exemption*, NDTV PROFIT (Nov. 21, 2017), https://www.ndtvprofit.com/law-and-policy/insolvency-law-case-for-tax-exemptions.
[71] *Id.*

SICA should be compared.[72] The organisation highlighted the irony of charging MAT on paper profits arising solely from IndAS entries, rather than from any realised income, thereby undermining the protection envisaged for stressed enterprises.[73]

Be it jurisdictional comparison or inspiration from scholarly studies and suggestions, the argument for favourable tax treatment regarding haircuts is persuasive. International models, historical Indian precedents, and institutions' normative frameworks, such as those of the World Bank and UNCITRAL, all point to a clear policy imperative: resolution-driven waivers should not lead to taxation. Reforms to harmonise India's taxation policy with its insolvency law would not only promote greater adoption of PPIRP but also signal the seriousness of the legal framework in achieving true economic rehabilitation. In the long run, harmony ensures that insolvency will no longer be a stigmatising last resort but rather an initiative-driven, revival-focused programme benefiting all stakeholders.

5 POLICY RECOMMENDATIONS: ADVOCACY FOR A FAVOURABLE TAX TREATMENT[74]

While interpreting taxing statutes, equitable considerations are entirely out of place; they cannot imply anything not expressly provided for.[75] This section proposes a suite of targeted legislative interventions to deliver tax neutrality for debt waivers under PPIRP. It also provides protection mechanisms or anti-abuse provisions to prevent fiscal abuse, ensuring the proposed framework remains robust, principled, and aligned with the broader aims of the Insolvency and Bankruptcy Code (IBC).

5.1 Statutory Exemption

The Income Tax Act, 1961, should incorporate an explicit provision to exempt all the income accrued from haircuts given to the MSME debtors going through the PPIRP. The same can be implemented by introducing a new clause under section 10 (which lays down those incomes that are exempted from taxation)[76] i.e. as clause (*51*) of section 10. The said provision can be drafted based on the model provision provided below:

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[72] *Waive Certain Taxes for Companies in Insolvency Proceeding: Assocham*, ECON. TIMES (Sept. 13, 2017), https://economictimes.indiatimes.com/news/economy/policy/waive-certain-taxes-for-companies-in-insolvency-proceeding-assocham/articleshow/60495542.cms?from=mdr.

[73] *Id.*

[74] To draft the model provisions herewith, the scheme and language as used in the Income Tax Act is mimicked.

[75] LSE Sec. Limited v. Commissioner, 2013 (29) S.T.R. 591.

[76] The Income Tax Act, 1961, § 10.

> "10. In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included[77]….
>
> (51) any income, whether in cash or in kind or partly in cash and partly in kind, arising from a remission, waiver, or reduction of a liability, whether trading or non-trading in nature, under a resolution plan approved by the Adjudicating Authority under Chapter III-A of the Insolvency and Bankruptcy Code, 2016.
>
> Explanation.– For this clause, the expression "Adjudicating Authority" shall have the meaning assigned to it in clause (1) of section 5 of the Insolvency and Bankruptcy Code, 2016."

On the contrary, separate exemption clauses may be incorporated into individual provisions used to levy taxes in the present context, i.e., sections 28(iv) and 41(1), if the legislature believes this would provide greater clarity. They could be included in the form of a proviso under these sections by following the models below:

> "S. 28….(iv)…
>
> Provided that nothing contained in this clause shall apply to any income, whether in cash, or in kind, or partly in cash and partly in kind, arising from a remission, waiver, or reduction of a liability, under a resolution plan approved by the Adjudicating Authority under Chapter III-A of the Insolvency and Bankruptcy Code, 2016.
>
> Explanation.– For this clause the expression "Adjudicating Authority" shall have the meaning assigned to it in clause (1) of section 5 of the Insolvency and Bankruptcy Code, 2016."
>
> AND
>
> "S. 41…(1)…
>
> Provided that nothing contained in this clause shall be applicable to any income, arising from a remission, waiver, or reduction of a liability, whether trading or non-trading in nature, under a resolution plan approved by the Adjudicating Authority under Chapter III-A of the Insolvency and Bankruptcy Code, 2016.
>
> Explanation.– For the purposes of this clause the expression "Adjudicating Authority" shall have the meaning assigned to it in clause (1) of section 5 of the Insolvency and Bankruptcy Code, 2016."

5.2 Deeming Provision (for S. 115JB)

To address the problem of book profit inflation under section 115JB due to accounting standards (e.g., IndAS 109), the author believes that including a deeming clause would

[77] *Id.*

improve the flow and clarity in the application of legislative intent. A proviso could be added to s. 115JB and the same could follow the below-mentioned model:

> "Provided that the income incurred due to a loan waiver given to the corporate debtor under a resolution plan approved by the Adjudicating Authority under Chapter III-A of the Insolvency and Bankruptcy Code, 2016, shall not be deemed to be a part of book profits under this section.
>
> Explanation.– For the purposes of this clause the expression "Adjudicating Authority" shall have the meaning assigned to it in clause (1) of section 5 of the Insolvency and Bankruptcy Code, 2016."

For the purposes of this deeming clause, taking inspiration from the cases of *JSW Steel Ltd.* and *Shree Cement Ltd.*, the income (aforementioned) may also be deemed as a *'capital receipt'*, which would have the same impact as the above model clause.

5.3 Tax Relief Outside of PPIRP

Looking beyond, the author would also like to suggest certain policy initiatives that could be applied to restructuring/insolvency proceedings apart from PPIRP. These suggestions are made with the view that, upon the successful implementation of a favourable tax regime for MSMEs undergoing PPIRP, the legislature may feel the need to revamp taxation policy across the entire insolvency sector. Here, the author proposes a strategic exemption method with a discretionary relief mechanism administered by the NCLT or the CBDT under section 119 of the Income Tax Act.[78] This could be notified through a circular by the CBDT or added as a provision in the Income Tax Act. This could be drafted as:

> "(1) Notwithstanding anything contained in any other law for the time being in force, where any income arises to a corporate debtor by reason of waiver of a loan or debt by a financial creditor or operational creditor in pursuance of a resolution plan approved under the Corporate Insolvency Resolution Process, the Adjudicating Authority (or CBDT, as the case may be) may, upon application made by the corporate debtor, direct that —
>
> (a) the whole or any part of the tax payable in respect of such income shall be waived; or
>
> (b) such tax liability shall be reduced to such extent as it may deem fit, subject to the satisfaction of the following conditions:
>
> (i) that the payment of such amount would cause genuine hardship to the corporate debtor; and

[78] *Id.* § 119.

(ii) that the corporate debtor has co-operated in good faith with all proceedings under the Corporate Insolvency Resolution Process.

(2) An application under sub-section (1) shall be submitted along with the resolution plan for consideration by the Adjudicating Authority, along with such supporting documents as may be prescribed.

Explanation. – For the purposes of this section, the expressions "Adjudicating Authority", "Corporate Debtor", and "Corporate Insolvency Resolution Process" shall have the meanings respectively assigned to them in clause (1) of section 5, (8) of section 3 and, Chapter III of the Insolvency and Bankruptcy Code, 2016."

5.4 Anti-Abuse Provisions

While the above proposals aim to preserve the economic integrity of the insolvency process, there may be situations in which these provisions are used opportunistically, calling for strong fiscal restraint to prevent fraudulent activity. These provisions could either be added as further provisos to the above provisions or be circulated as circulars/notifications by the concerned authority.

The safeguard provisions may include:[79]

1. A three-year business continuity clause: The MSME debtor availing the tax benefits must continue to run the same business for a minimum period of three years post-resolution. This is to ensure that the process is not arbitrarily used to carry out shell acquisitions.
2. Lock-in periods for shareholders: If the resolution results in new shareholders acquiring a stake in the company, their equity shall be locked in for a period of three years. This is to ensure that speculative investors do not flip post-tax benefits.
3. Independent audits post-resolution: Upon successful implementation of the resolution plan, independent audits by a third-party must be conducted to guarantee that the process is not misused with fraudulent intentions.

The above safeguards are merely indicative, and other such provisions must be further explored. It is important to note that the three-year cooling period applicable to an MSME debtor opting for PPIRP also serves as an inherent deterrent to prevent arbitrary abuse of the tax reliefs. These conditions not only allow for restricting actions taken in bad faith, but also boost public confidence in the framework's accountability and transparency, which is often considered lacking in PPIRP.[80]

[79] All the time periods mentioned are just indicative and could be amended as per the wisdom of legislative policy.
[80] Rout & Shankar, *supra* note 4, at 91.

6 CONCLUSION

As India's insolvency framework evolves, achieving a balance between fiscal and insolvency frameworks is central to the success of efforts like the PPIRP. In this paper, the author argues that taxing haircuts, although legally justified by existing statutory provisions, is a policy anomaly that erodes the economic rationale and legislative intent of MSME-focused insolvency resolution. The tax obligation on notional gains as real taxable income in restructuring cases distorts creditors' and debtors' incentives, making recovery even more elusive.

The broader lesson of this paper is that insolvency law cannot be imposed fiscally in a vacuum. The revival of distressed businesses, particularly MSMEs, must be supported by a legal framework that makes tax policy a catalyst rather than a hindrance to economic revival. This requires legislative foresight and inter-regulatory harmonisation, in which the Income Tax Act must evolve in concert with the IBC's architecture.

The paper provides a way forward for further legislative and academic experimentation. Future studies can examine the viability of combined insolvency-fiscal codes by conducting empirical research charting the effects of tax burdens on resolution outcomes across different classes of debtors, particularly in the MSME sector, or by using econometrics to quantify the exchequer's potential revenue loss relative to the economic benefit of improved resolution outcomes.

Above all, India's insolvency system cannot be perceived as a discrete process of debt restructuring but as an economic rebirth tool. In that perspective, tax neutrality on resolution-facilitated haircuts is not a concession but an institutional necessity. Only then can tools like the PPIRP effectively realise their potential as agents of sustainable and equitable enterprise revival.

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